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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 911

J. E. DAVANT, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The issue presented by this tax case is whether the transfer of assets from one corporation controlled by petitioners to another is a "reorganization" so that approximately $817,000 in cash which petitioners received from the corporations is taxable as a dividend. The pertinent provisions of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 13–15.

Petitioners owned all of the outstanding stock of two corporations, Warehouse and Water, which were engaged in complementary businesses. In 1960 they proposed a plan whereby (1) Warehouse would transfer all its assets (except $230,000 cash) to Water for

$700,000 cash, and (2) Warehouse would then liquidate and distribute the approximately $930,000 cash to petitioners. Petitioners would continue to own all of Water's stock, which would operate the businesses formerly owned by both Warehouse and Water. (R. 192–196, 211–212.)[1]

Because of the danger that this transaction might constitute a "reorganization" with the $930,000 treated as "boot" and thus taxable at least in part as a dividend, petitioners' attorney recommended that the plan be changed somewhat. Thus, petitioners sold all their stock in Warehouse to their attorney's son (Homer Bruce, Jr.) for approximately $915,000; Warehouse sold its operating assets to Water for $700,000 and liquidated, distributing $930,000 cash to Bruce, Jr. Bruce, Jr., repaid the $915,000 he had borrowed to purchase Warehouse's stock from petitioners and had a $15,000 profit left over. The entire series of transactions took place pursuant to a preconceived plan during a period of approximately one hour. (R. 212–223.)

Petitioners claimed that they had sold Warehouse's stock to Bruce for $915,000 and that they were entitled to capital gain treatment. The Commissioner took the position that Bruce, Jr., had been used as a conduit and that his participation should thus be disregarded, that the transfer of assets from Warehouse

[1] "R" references are to the printed record in the court of appeals in *South Texas Rice Warehouse Co.* v. *Commissioner*, petition for a writ of certiorari pending, No. 910 this Term, a companion case involving the same parties which was consolidated with the instant case in the Tax Court.

to Water (both of which were wholly owned by petitioners) was a reorganization, and that the $915,000 cash received by petitioners was thus a "boot" distribution taxable as a dividend. (R. 227-228.)

The Tax Court agreed with the Commissioner's determination, and held that the transaction, viewed as a whole, constituted a "D" reorganization. See Code § 368(a)(1)(D) (App., *infra*, p. 15). However, the Tax Court held that the $915,000 distribution to petitioners was taxable to them as dividends under § 356(a)(2) only to the extent of Warehouse's accumulated earnings and profits (approximately $117,000). (R. 251-254.) The court of appeals affirmed the Tax Court's holding that the transaction constituted a reorganization and accepted the Commissioner's argument that since $700,000 of Water's accumulated cash, as well as $215,000 of Warehouse's cash, was being distributed, petitioners were taxable as a dividend to the extent of both corporations' earnings and profits.[2]

The decision below was correct, and there is no conflict of decisions or other reason for review by this Court.

1. In general, if substantially all the assets of a corporation (here Warehouse) are transferred to another corporation (here Water) which is controlled by the transferor corporation or its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§ 368(a)(1)(D), 354(b). If the transferor corpo-

[2] The court of appeals ordered a remand to determine Water's earnings and profits (Pet. 55). For purposes of the instant discussion we assume that its earnings and profits are $700,000.

ration (Warehouse) then liquidates and distributes cash to its stockholders (petitioners), this cash constitutes "boot" and is taxed as a dividend to the extent of the earnings and profits, if it "has the effect of the distribution of a dividend." Code §356(a)(2).

The theory behind this treatment is as follows: If Warehouse and Water had simply distributed $915,000 cash, the stockholders (petitioners) would have been taxed as a dividend to the extent of the corporations' earnings and profits. If Warehouse transferred its operating assets to Water, which was essentially a continuation of Warehouse, and the two corporations also distributed the cash to their stockholders, the distribution should result in taxable dividends to the extent of the corporations' earnings and profits, just as if the transfer from one corporation to the other had not taken place.

The Code accomplishes this result by taxing as a dividend property ("boot") distributed to shareholders incident to a reorganization. Petitioners argue, however, that (1) even though Warehouse's business continued uninterrupted in a new corporate shell (Water) owned by the same shareholders, the instant transaction nevertheless does not constitute a reorganization and (2) they should be allowed to withdraw part of Warehouse's and Water's undistributed profits at the capital gains rate.[3]

[3] If the transaction does not constitute a reorganization, 1954 Code § 331 dealing with complete liquidations would apparently make petitioners' profit on the transaction a capital gain. If, on the other hand, the transaction is a reorganization, § 331 would be inapplicable. See *Commissioner* v. *Estate of Bedford*, 325 U.S. 283, 291.

(a) Petitioners contend that they did not control both the transferor (Warehouse) and the transferee (Water) immediately before and after the transaction. They argue that they had sold their stock in Warehouse to Bruce, Jr., for $915,000 and that he independently decided to have Warehouse sell its assets to Water. As both lower courts recognized, Bruce, Jr., acted merely as a conduit (R. 243–244; Pet. 35). In one hour pursuant to a prearranged plan, he (1) purchased all the stock of Warehouse from petitioners, borrowing $915,000 to pay for it, (2) had Warehouse sell its operating assets to Water (which was wholly owned by petitioners), (3) liquidated Warehouse, receiving $930,000 cash, (4) repaid the $915,000 loan, and (5) retained $15,000 as a profit or fee. At most he held title to the stock of Warehouse only momentarily while the preconceived plan was carried out. As the court of appeals commented in affirming the Tax Court's holding that Bruce was merely a conduit, "It is hard to imagine a transaction more devoid of substance than the purported 'sale' to Bruce, Jr." (Pet. 35). See, *e.g.*, *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184–185; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613–614.

(b). Petitioners also contend that even if they controlled both corporations immediately before and after the transaction, it constituted a sale rather than a reorganization because Warehouse received cash rather than Water stock in exchange for its assets. The courts, however, have long rejected such formalistic arguments and held that whenever one corpora-

tion transfers its essential business enterprise to another corporation *which is controlled by one or more of the transferor corporation's stockholders*, the transaction constitutes a "D" reorganization, regardless of the form in which the transaction is cast. See, *e.g.*, *Lewis* v. *Commissioner*, 176 F. 2d 646 (C.A. 1); *Love* v. *Commissioner*, 113 F. 2d 236 (C.A. 3); *Bard-Parker Co.* v. *Commissioner*, 218 F. 2d 52 (C.A. 2), certiorari denied, 349 U.S. 906; *Liddon* v. *Commissioner*, 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Commissioner* v. *Morgan*, 288 F. 2d 676 (C.A. 3), certiorari denied, 368 U.S. 836; *Moffatt* v. *Commissioner*, 363 F. 2d 262 (C.A. 9), petition for certiorari pending, No. 804, this Term; *Reef Corp.* v. *Commissioner*, 368 F. 2d 125 (C.A. 5), petition for writ of certiorari pending, No. 1005, this Term; *Babcock* v. *Phillips* (C.A. 10), decided January 27, 1967, petition for certiorari pending, No. 1215, this Term.

Petitioners argue that in order for a "D" reorganization to take place, the transferee corporation (Water) must give some of its stock to the transferor corporation (Warehouse) in consideration for the latter's assets. Since petitioners owned all the stock of both Warehouse and Water, it made no difference to them whether Water paid for Warehouse's assets in part by issuing some of its own stock; this would merely have increased the number of shares of Water common stock which petitioners owned, but would not have effected any substantive change in their ownership. Moreover, such a rule would make "D" reorganizations completely optional. If petitioners had

desired to effectuate a reorganization, Water could have given a few shares of its stock plus $700,000 for Warehouse's assets. If petitioners wished to avoid the reorganization sections of the Code, Water would merely pay for Warehouse's assets entirely in cash. Therefore, the lower court was clearly correct in concluding, as have all the other courts which have passed on the question, that "To require the actual transfer of stock certificates where such a transfer would be a meaningless gesture would be to make the reorganization provisions optional with the taxpayer, a result which Congress clearly did not intend" (Pet. 49). Accord: *Liddon* v. *Commissioner, supra; Commissioner* v. *Morgan, supra; Heller* v. *Commissioner*, 2 T.C. 371, affirmed 147 F. 2d 376 (C.A. 9), certiorari denied, 325 U.S. 868; *Moffatt* v. *Commissioner, supra; Babcock* v. *Phillips, supra.*[4]

[4] Contrary to petitioners' contentions, neither the result reached by the court of appeals nor its reasoning is in conflict with any other appellate decision. Petitioners argue at length that the instant decision conflicts with *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462, and *Cortland Specialty Co.* v. *Commissioner*, 60 F. 2d 937 (C.A. 2), certiorari denied, 288 U.S. 599 (Pet. 16–17). In cases like *Pinellas* and *Cortland* a corporation transferred its assets to another corporation in exchange for cash and short term notes, and the stockholders of the transferor corporation did not own any stock in the transferee. Thus the courts held that such a transaction did not constitute a reorganization because the "continuity of interest" requirement was not met, *i.e.*, the stockholders of the transferor corporation had no continuing equity interest in the transferee. See also *Helvering* v. *Watts*, 296 U.S. 387, and *Le Tulle* v. *Scofield*, 308 U.S. 415. In the instant case, however, the "continuity of interest" requirement was clearly satisfied, since the stockholders of the transferor corporation (Warehouse) owned all the stock of the transferee (Water).

(c) Petitioners argue that even if the transaction constitutes a "D" reorganization, the $915,000 distribution is taxable as a dividend only to the extent of Warehouse's earnings and profits (*i.e.*, $117,000) and not, as the court of appeals held, to the extent of the combined earnings and profits of Water and Warehouse. The court of appeals correctly recognized that there are at least two reasons for rejecting petitioners' argument. *First*, it is clear that if the day before the reorganization Warehouse and Water had each distributed their accumulated earnings to petitioners (who owned all the stock of both corporations in identical proportions), the distributions would have been taxable as dividends to the extent of both corporations' earnings and profits. Instead of causing Warehouse and Water to distribute, respectively, $215,000 and $700,000 directly to petitioners, the parties used Warehouse as "a conduit through which [the $700,000] passed from Water to Water's stockholders [i.e., petitioners]. The effect was precisely the same as if Water had passed [the $700,000] directly to its stockholders" (Pet. 51). Thus, the court of appeals recognized that "two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend [of $817,000 from the two corporations] and the other a reorganization [combining the two corporations]" and that merely by carrying out the two transactions at the same time the parties cannot reduce the amount of the dividend subject to tax from $817,000 (the combined earnings and profits of the two corporations) to

$117,000 (Warehouse's earnings and profits) (Pet. 52).

Second, the court of appeals held that the language of § 356 required the result which it reached. That section provides that when a taxpayer receives boot as part of a merger, the boot shall be taxed as a dividend to the extent of the earnings and profits of the distributing corporation. Of course, if both merging corporations distribute boot to their stockholders, each group of stockholders would be subjected to a dividend tax to the extent of the earnings and profits of the corporation in which they owned stock. In the instant case, petitioners owned stock in both corporations, and both, in substance, made distributions to petitioners. Water distributed $700,000 of its accumulated earnings to petitioners and Warehouse distributed $215,000 to petitioners. As the court of appeals observed, "When there is complete identity of stockholders, the use of earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend" (Pet. 53). Otherwise, if form is allowed to control, the wholly illogical result would be reached that if Water were merged into Warehouse, the amount of the dividend would be measured by Water's earnings and profits ($700,000), but if Warehouse were merged into Water, the dividend would be limited to Warehouse's lesser earnings and profits ($117,000), despite the fact that in substance exactly the same result would be reached. Therefore, the court of appeals correctly concluded that "in this case there were two distribut-

ing corporations," Warehouse to the extent of $215,000 and Water to the extent of $700,000, and that "Warehouse was a conduit for Water's distribution of $700,000 and thus, in determining which corporation was the distributing corporation for purposes of § 356(a)(2), we look through Warehouse and reach Water" (Pet. 54).

Moreover, the result reached by the court of appeals prevents the use of the reorganization sections to escape taxation by converting into capital gains distributions which are in effect dividends out of accumulated earnings and profits, and is in accord with the announced objectives of Congress in enacting the corporate reorganization and related dividend provisions of the 1954 Code—namely, "to insure that transactions which are in substance, although not in form, dividend distributions * * * are subject to tax at ordinary income rather than at capital gain rates." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42.[5]

2. Petitioners' principal contention (Pet. 6, 13) is that the court below erred in holding that the instant transaction constituted an "F" reorganization, *i.e.*, "a mere change in identity, form, or place of organization, however effected" (§ 368(a)(1)(F), App. *infra*, p. 15), and that such holding is in conflict with *Helvering* v. *Southwest Consolidated Corp.*, 315 U.S. 194.

[5] Finally, at least on the question whether the amount of the dividend is to be determined from Warehouse's or from both corporations' earnings and profits, the result depends on the rather unusual facts of this case—where both corporations are owned by the same shareholders. There is no conflict of decisions and further review is not warranted.

The result reached by the court of appeals is completely supported by its conclusion that the transaction is a "D" reorganization (discussed *supra*, pp. 3–7), and, as the court itself recognized, its conclusion that the transaction also constitutes an "F" reorganization is an alternative holding. The government did not urge the "F" theory before the court of appeals, but argued only that the transaction was a "D" reorganization. And the government does not press the "F" argument here.[6] Therefore, the instant case is not an appropriate one in which to test the limits of § 368 (a)(1)(F).[7]

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[6] In the companion case of *Reef Corp.* v. *Commissioner*, 368 F. 2d 125 (C.A. 5), petition for writ of certiorari pending, No. 1005, this Term, the government argued that the transaction constituted an "F" reorganization and the court of appeals correctly accepted the argument. As the government points out in its Memorandum in Opposition in *Reef*, that case involved a transfer of virtually all the operating assets of an existing corporation (Reef Fields) to a newly formed corporation (Reef) controlled by the same stockholders. Such a transaction clearly qualifies as an "F" reorganization. The Commissioner is not taking the position that the merger of two established corporations (*e.g.*, Warehouse and Water), both of which have long been engaged in business, constitutes an "F" reorganization merely because the stockholders of both corporations are identical. Such a transaction clearly qualifies as a "D" reorganization, as the court of appeals held, and there is no need to consider the "F" question at this time.

[7] In any event, the decision below does not conflict with this Court's decision in *Southwest Consolidated*, for in holding that no "F" reorganization occurred in that case the Court stressed (pp. 202–203) the change in ownership of the stock of the transferor and transferee corporations, whereas in the instant case the stock ownership was identical.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1967.

APPPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

* * *

* * * * *

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.

(a) *General Rule.*—

(1) *Complete liquidations.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

* * * * *

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) *General Rule.*—

(1) In general.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of

the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(b) *Exception.*—

(1) *In general.*—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

* * * * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges.*—

(1) *Recognition of gain.*—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.*—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February

28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * * *

(F) a mere change in identity, form, or place of organization, however effected.

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

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